

Memorandum

Iowa Citizens' Aide/
Ombudsman



TO: Legislative Oversight Committee
FROM: Jeff Burnham, Senior Assistant Ombudsman
(reviewed and approved by William P. Angrick II)
RE: Ombudsman Investigation Concerning Iowa Lottery
Date: January 22, 2008

TWO \$250,000 WINNERS

The Iowa Lottery issues many press releases about customers winning big prizes. One press release last April told of a woman who, while giving a friend a ride home, decided to see her husband at the store that they own together.

Once at the store, her husband said to her, “Here, why don’t you just scratch some lottery tickets?”

The press release said the woman “scratched the tickets on the spot and revealed the big winner” for a quarter of a million dollars.

She was not the only retailer or retailer employee to win big money playing the Iowa Lottery last year. A convenience store clerk won two big prizes last January. The first was for \$10,000. Three weeks later, the clerk won again – this time for a quarter of a million dollars. Both prizes came from instant-scratch tickets from the store where she works.

And she was not done winning. The store clerk had four more wins later in the year, each for \$1,000. All told, she had six wins in 2007 for a total of \$264,000.

CANADIAN LOTTERIES/RETAILER FRAUD & THEFT

At the time of the store clerk’s \$250,000 win in January 2007, the Iowa Lottery had already been tracking reports about possible retailer fraud involving two Canadian lotteries. It was alleged that Canadian retailers and their employees had been winning significantly more major prizes than they possibly could by chance.

One media report in Ontario included analysis from a statistician who concluded that the rate of retailer wins for online games was at least 3.5 times more than expected; and the rate of retailer wins for instant ticket games was about 15 times more than expected.

Canadian media reports alleged that some retailers and retailer employees were able to trick customers into thinking they had won a minor prize, or no prize, when in fact they had won a major prize. The most infamous case involved a retailer who cheated an elderly man out of a winning ticket worth \$250,000.

In response to those reports, ombudsman offices in Ontario and British Columbia initiated major investigations.

By the time of the Iowa store owner's \$250,000 win in April 2007, the Ontario Ombudsman had released a public report that criticized the Ontario lottery for failing to protect its customers. The ombudsman's report found that the lottery's lax approach to enforcement had enabled some retailers and clerks to manipulate the process to their own advantage, up to and including theft of some customers' winning tickets. They were able to do this by using their status as "insiders" – the person behind the counter who customers hand their ticket to in order to see if it's a winner.

The Ontario lottery's complaint files showed that some customer victims later figured out what happened and complained to the lottery. But the ombudsman reasoned that there were probably many cases that had gone undetected – they involved the customer victims who never realized what happened.

A month later, the British Columbia Ombudsman released a public report that reached similar conclusions about that province's lottery.

Both reports concluded that the only way to confidently rule out retailer fraud and theft is to track and proactively investigate all major prize claims by retailers and retailer employees.

The reports found that the weakest links in the system are customers who aren't familiar with the rules of lottery games, putting them most at risk to potential fraud and theft. The British Columbia report quoted a retailer as follows:

If the player doesn't understand how to play the ticket, it's quite easy for the retailer to look at the ticket and tell them it's not a winner, throw it into their garbage or recycling, and retrieve it later and validate it.

Since the ombudsman reports, there has been a sea change in how the Ontario and British Columbia lotteries view the importance of protecting their customers' interests. Similar problems have since been found involving at least one other Canadian lottery.

REPORTS FROM OTHER STATES

There have not been any similar investigations in the United States. This could create the impression that the threat of retailer fraud is a distinctly Canadian problem. But that impression is contradicted by media reports over the past several years.

A few months ago, a store clerk in California was charged with grand theft in connection with a winning ticket worth more than half a million dollars. She allegedly tricked the customer by telling him that he had only won \$4.

Here in the Midwest, a Kansas store clerk was prosecuted in 2002 after telling a customer that he had won \$100 when in fact he had won more than \$250,000 in 2002.

It should be emphasized that these are incidents where the employee was caught and prosecuted. It stands to reason that there may be other incidents that are going undetected.

IOWA OMBUDSMAN INVESTIGATION

In light of the Canadian ombudsman investigations, Iowa Citizens' Aide/Ombudsman Bill Angrick directed me to review those reports and assess whether the Iowa Lottery has sufficient safeguards to ensure that prize monies are going to the rightful owners of winning tickets. I submitted a preliminary response to Mr. Angrick last fall, after which he issued a formal notice of investigation and request for information to the Iowa Lottery on October 5.

The remainder of this presentation will describe some of the specific concerns that are subject to further investigation by our office.

NO AUTOMATIC SCRUTINY OF PRIZE CLAIMS FROM IOWA RETAILERS

Part of the criticism of the Canadian lotteries centered on inadequate enforcement of their "insider win" policies, which require automatic investigations of all major prize claims by retailers and retailer employees.

The Iowa Lottery has no comparable "insider win" policy. In his November 5 written responses to our questions, Mr. Brickman wrote that the Iowa Lottery does not investigate major prize claims of anyone – including retailers and store clerks – "unless there are circumstances involved that would indicate an investigation is warranted."

It does not appear that the Iowa Lottery investigated either of the two prize claims mentioned earlier, where a store owner and a store clerk each won \$250,000. The Lottery paid those claims even as it was tracking reports from Canada about concerns with such claims.

The British Columbia Ombudsman pointed out that enforcement that is typically only triggered by complaints has a "fatal flaw," writing:

[The lottery] only became involved ... if a customer complained. [The lottery] put the onus on the player to protect him or herself. **A fatal flaw, however, was if the player did not know or observe enough to conclude he or she had been taken advantage of then he or she would not complain at all.** [emphasis added]

We are concerned that the Iowa Lottery's position could be leaving customers unnecessarily vulnerable. If theft or fraud occurs without the awareness of the customer victim, it is unclear how it would ever come to the attention of the Iowa Lottery.

TICKET OWNERSHIP: "BEARER INSTRUMENT" STANDARD

Another concern involves Iowa's "bearer instrument" standard for ownership of lottery tickets. Essentially, until a ticket is signed, it is owned by the person who holds it. This is spelled out in two administrative rules, based on Iowa Code section 99G.31, which says prizes "shall be given to the person who presents a winning ticket."

In the context of potential clerk fraud, the "bearer instrument" standard would not seem to bode well for any customer who hands over an unsigned ticket to a clerk. This is best illustrated by a passage from the Ontario Ombudsman's report. It referred to a memo by an Ontario lottery manager, which dealt with a recommendation that the lottery move to a "bearer instrument" policy. Another manager responded in an e-mail:

If we move to a pay-the-bearer policy, Prize Office staff will no longer make efforts to determine if a ticket is being presented [for] payment by the proper parties. If we don't ask basic questions to determine ownership at the time of redemption it will have implications with respect to stolen tickets ... [and] insider wins.... Our ability to deal with these issues will be eroded.... [emphasis added]

Here we have an Ontario lottery manager, asserting that the lottery's ability to investigate potential retailer fraud would "be eroded" by switching to a "bearer instrument" standard – the same standard the Iowa Lottery has gone by since at least the early 1990s. And keep in mind, the Ontario lottery was found to have significant problems involving fraud and theft, even without a "bearer instrument" standard.

BACKGROUND CHECKS & RETAILER "CODE OF CONDUCT"

In attempting to differentiate itself from the Canadian lotteries, the Iowa Lottery trumpets two practices. The first is that it conducts background checks of any retailer who applies for a license to sell Iowa Lottery products. Anyone with a conviction for a felony, fraud or gambling violation is not allowed to have a license.

Background checks are certainly a good tool, but they have limitations. In particular, a background check doesn't apply to a store's employees, who make up the vast majority of individuals who process Iowa Lottery tickets for customers. In other words, an employee who has a conviction for fraud or gambling-related offenses would not be detected by the Lottery.

The Iowa Lottery also points to its contract with licensed retailers, also referred to as a "code of conduct." Similar to the background checks, the contract with retailers is a good tool, but also has limitations. Neither a background check nor a written contract can replace the importance of proactively policing areas of potential fraud and theft. A background check and a code don't stop people from giving in to temptation.

DIFFERENCES IN DEFINITION OF "INSIDERS"

As mentioned previously, the Canadian lotteries consider retailers and their employees to be "insiders" who should be subjected to additional scrutiny when they claim major prizes.

In a memo to the Lottery Board last November, Mary Neubauer, Lottery Vice President for External Relations, noted that Iowa law does not define retailers and their employees as "insiders." She wrote that retailers "don't have access to confidential information associated with the lottery and they can't affect the outcome of drawings."

I will grant that retailers and their employees don't have access to "inside information" and can't affect the winning numbers that are drawn. **But retailers and their employees have two things that nobody else has: Direct access to customers' tickets, and direct control over the process of validating those tickets to see if they are winners.**

CUSTOMERS NOT RECEIVING VITAL INFORMATION

One of our questions to the Lottery dealt with the issue of customers relying on lottery terminals to find out if a ticket is a winner. In response, Mr. Brickman stated:

[C]ustomers should not rely solely on any one source of information to determine the winning or nonwinning status of lottery tickets. There can be malfunctions with individual terminals just as there can be malfunctions with any electrical or mechanical device in existence.

... Additionally, the media that reports lottery numbers ... can sometimes report incorrect information, a situation over which the lottery has no control....

He then explained that customers have a number of available sources for winning numbers, including the Lottery's website and having a clerk scan a ticket through a terminal. Mr. Brickman added, "Employing more than one of those sources of information can give more assurance to players that they have determined the true status of their tickets."

It should be noted, however that the Iowa Lottery's own press releases are replete with examples of winning customers who say they rely exclusively on store clerks to check their numbers. One such press release was about a man who won \$10,000 playing Powerball. The press release stated:

[The man] always has the store clerk check his tickets for him. He had no idea that he held a big winning ticket the day after the drawing when he had it checked!

"It was quite a surprise," he laughed.

The press release gave no indication that the customer was engaging in a practice that is actually discouraged by the Iowa Lottery.

Moreover, I have scoured the information that the Lottery provides to customers through its website, the backs of tickets and point-of-sale literature. I have not been able to find anything that cautions customers against relying solely on any one source of information for winning numbers; or alternatively, of customers being encouraged to employ more than one source of such information.

This raises a concern about the Lottery's perspective that customers have the ultimate burden for protecting themselves. Ms. Neubauer made this point in her recent memo to the Iowa Lottery Board, in which she wrote:

The first line of defense in consumer protection is always for players to arm themselves with the information they need to determine whether their tickets have won a prize. The lottery offers its players a plethora of information they can use to determine the outcome of their tickets. However, we have felt that there is no substitute for player responsibility and player diligence, despite all the assistance that we can provide.

However, it will be rather difficult for customers to exercise "player responsibility" and "player diligence" if the Iowa Lottery doesn't share basic advice about how they can best protect themselves from potential risks.

Finally, Mr. Brickman's admission of possible errors in the sources for winning numbers is also potentially significant. The Lottery annually reports more than \$1 million in unclaimed prizes – prizes that are won but never claimed. In fiscal year 2007, the amount of unclaimed prizes was nearly \$1.8 million. Nearly 80 percent of those funds reverted back to the Lottery, and ultimately to the state general fund. In other words, the more unclaimed prizes there are, the more money that goes back to the state.

SIGNIFICANT IMPROVEMENTS TO CANADIAN LOTTERIES – MOST NOT EVIDENT IN IOWA

In her November memo to the Lottery Board, Ms. Neubauer wrote:

After consumer complaints in Ontario and Quebec, the lotteries there each have spent hundreds of thousands of dollars on consultants' evaluations of their systems. They are now in the process of implementing many of the consultants' suggestions for improvements, which have turned out to be some of the things we already have been doing for years.

In actuality, the lotteries in Ontario and British Columbia have each implemented dozens of improvements over the last year or so. Some were recommended by consultants hired by the lotteries. But many others were recommendations by the provincial ombudsmen (and didn't cost the lotteries a dime).

Based on a review of the dozens of changes that have been implemented by the Canadian lotteries, and my understanding of the procedures that are in place for the Iowa Lottery, it appears that many of the Canadian improvements go beyond anything that the Iowa Lottery has been doing.

For example, just in Ontario:

- Retailers are now forbidden from checking any tickets that have not been signed by the customer.
- The lottery website now has a public statement confirming its commitment to take all reasonable steps to ensure the integrity and honesty of the retailers that serve the lottery system.
- In response to the ombudsman's most significant recommendation, oversight of retailers has been removed from the provincial lottery and reassigned to another agency independent of the lottery system.

LOTTERY DENYING OMBUDSMAN'S REQUEST TO REVIEW COMPLAINT INVESTIGATION FILES

Our office's written notice of investigation to the Lottery included a number of questions and information requests. With one exception, the Lottery has thus far cooperated with our investigation.

The one exception involves our request that the Lottery make available, for our review, all of its investigative files and/or records for calendar years 2006 and 2007 involving the actions of retailers, retailer employees and Lottery terminals. We believe that our

investigation would be incomplete without reviewing how the Iowa Lottery has been responding to customer complaints.

The Iowa Lottery's acting CEO, Ken Brickman, has denied our request to review the agency's complaint files. He claims those files are confidential under Iowa law.

The ombudsman does not agree with the basis of Mr. Brickman's denial. Our legal counsel recently submitted a letter of response delineating our position and asking the Lottery to reconsider its position. Our letter asked for a response by January 28.

My interest in reviewing those files is enhanced because of a comment made to me several years ago by a Lottery employee. I had called the Lottery about a complaint that was unrelated to these issues. An employee explained that the customer in question had already reported his concerns to the Lottery's main office. She then added that complaints are "commonly handled by DSRs" or "district sales representatives."

There is a parallel here: The Canadian ombudsman investigations criticized their lotteries for often relying on sales personnel to look into customer complaints. It was noted that it is questionable, at best, to rely on sales staff to review complaints.

Mr. Brickman has asserted that the Iowa Lottery takes all complaints seriously and investigates them thoroughly. If that is the case, the Lottery should not have a concern about the ombudsman conducting an independent review of its complaint files – particularly since those files are not independently audited, according to Mr. Brickman.

CLOSING

Lotteries and the governments they report to have a self interest in protecting customers from potential risks. A lottery that does not adequately protect its customers risks losing their confidence, potentially harming the lottery and in turn the government it serves.

Certainly, there is not enough information at hand to show that anyone – particularly the two \$250,000 winners mentioned previously – has committed fraud or theft. At the same time, it is also clear that it would be naïve to assume, without further investigation, that retailer fraud and theft have not been occurring undetected in the Iowa Lottery.

If the committee has any questions for us, we would be happy to try to answer them. Thank you.